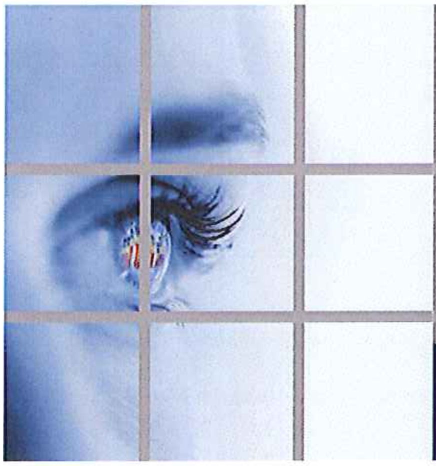


**Shropshire County Council**

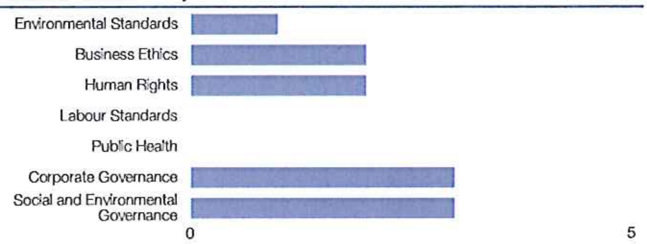
# Responsible Ownership Activity Report Q4 2013

The purpose of the ***reo***® (responsible engagement overlay)* service is to engage with companies held in portfolios with a view to promoting the adoption of better environmental, social and governance (ESG) practices. The ***reo***® approach focuses on enhancing long-term investment performance by making companies more commercially successful through safer, cleaner, and more accountable operations that are better positioned to deal with ESG risks and opportunities. Through a combination of constructive dialogue and active share voting, ***reo***® works to drive behavioural change with companies, and records successful outcomes as 'milestones' – changes in corporate policies or behaviour following intervention.

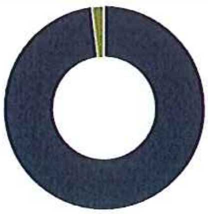
## Companies engaged this quarter

| | |
|---|---|
| Companies engaged | 49 |
| Milestones achieved | 11 |
| Countries covered | 2 |

Milestones achieved by issue

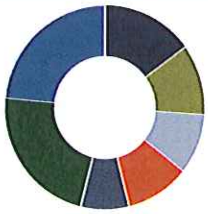



Companies engaged by country



| | |
|---|---|
| United Kingdom | 48 |
| Asia (ex Japan) | 1 |

Companies engaged by issue**



| | |
|---|---|
| Environmental Standards | 17 |
| Business Ethics | 13 |
| Human Rights | 11 |
| Labour Standards | 12 |
| Public Health | 9 |
| Corporate Governance | 26 |
| Social and Environmental Governance | 27 |

* ***reo***® is currently applied to £81.7 billion (€97.7 billion / $132.2 billion) of assets as at 30 September 2013

** Companies may have been engaged on more than one issue.



F&C Investments

reo® viewpoint

Yo Takatsuki, Senior Analyst, Governance and Sustainable Investment November 2013

# Japanese corporate governance: Beyond the tipping point?

For two hundred years Japan isolated itself, resisting change from the outside world. This came to a sudden end in 1854 with the arrival of the warships of American Commodore Matthew Perry. They brought with it the start of a process of rapid modernisation where Western influences were keenly absorbed into Japanese society.

Fast forward to 2013 and Prime Minister Shinzo Abe is trying to have a similarly dramatic effect. His government's policies are attempting to shake the country awake from a 20-year slumber defined by economic stagnation and deflation. How successful his popularly dubbed Abenomics will be in revitalizing Japan in the long-term remains open to debate. But, there is no question that – once again – Japan is open for change.

It is within this political and economic backdrop that F&C reports on a year of significant improvements to corporate governance practices in Japan. Despite its position as one of the largest capital markets in the world, Japan's corporate governance practices severely lag those of its developed world peers, and more recently, even those of some Asian neighbours such as Hong Kong and Singapore. Japan's largest corporations have a history of open resistance to governance reform and a track record of lobbying through industry bodies to dilute proposals for change, including the recent revisions to the Japanese Company Law. This allowed many companies to maintain outdated governance practices of concern to international, minority shareholders. The following problematic practices are a variation on the same theme — no voice for shareholders:

- **Management dominated boards with no outsiders** – As recently as 2010, more than half of the companies on the TOPIX is estimated to have all-insider boards. In effect, most Japanese boards still serve as management boards where strategy and execution is overseen by the same group of people. Minority shareholders are barely represented, if at all. This reflects the traditional weak position of shareholders in the running of a Japanese corporation where arguably management and employees have enjoyed much stronger influence.
- **Extremely low numbers of independent directors** – 0.2% of listed Japanese companies have majority independent boards. This compares to approximately 90% in the US, 50% in the UK and 30% in Singapore[1].
- **Concentration of power** – The chairman of the board is also almost always the most powerful executive in the company. This leads to questions over who is responsible for overseeing the actions and performance of management. It is not uncommon for the chairman to be a direct descendant of the founder. Traditionally, many chairmen further entrench their position through cross-share holdings with companies and banks they have close relationships with.

Nuclear apocalypse and fraud of breathtaking proportion provided some catalyst for change in 2011 as **Tokyo Electric Power Company's (TEPCO)** meltdown disaster at the Fukushima power plant and the **Olympus** accounting scandal focused international investors' attention on Japan. These incidents stimulated public debate on the companies' governance practices, especially on how it could have contributed or failed to stop the cases from occurring. Despite all this, revisions to the Company Law showed the determination of big businesses to maintain its insider dictated approach to corporate governance. A proposal to mandate the appointment of a single outside director was watered down to a "comply or explain" approach requirement following fierce resistance from the powerful Keidanren business lobby.

The return of Abe's Liberal Democratic Party to power in December 2012 sparked a sharp increase in the price of Japanese stocks – with the Nikkei 225 index rising by nearly 60% in six months of his re-election[2]. International investors were the major drivers of this bull-run, rushing into the market by purchasing an estimated net 50 billion dollars of Japanese shares[3]. Estimates suggest that 30% of the Japanese market is now owned by foreign shareholders – an all time high.

The flooding in of international investors with higher expectations for governance practice helped push reform up Japan's political agenda. Unlike previous years, many companies have dropped resistance and accepted change during the course of this year. At the end of September 2013, a record 112 companies (7% of TOPIX index issuers) had moved to end a regime of all-insider boards and opened the board to outsiders for the first time. In the future, 2013 may be the year in which governance reform could be considered to have gone beyond the tipping point.

## F&C Acts

F&C has been actively seeking change in Japanese corporate practices since 2000. We co-authored the Asian Corporate Governance Association's (ACGA) "White Paper on Corporate Governance in Japan" in 2008. This landmark study contributed to increasing interest among the international investor community in Japan Inc.'s approach to governance. The paper highlighted three weaknesses that resonate to this day[4]:

- Inadequate supervision of corporate strategy;
- Protecting management from the discipline of the market, thus rendering the development of a healthy and efficient market in corporate control all but impossible;
- Failing to provide the returns that are vitally necessary to protect Japan's social safety net – its pension system.

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[1] ISS data, September 2013
[2] ENikkei 225 rose by 58.99% between 17 December 2012 and 22 May 2013.
[3] Sumitomo Mitsui Trust Bank data, September 2013
[4] ACGA "White Paper on Corporate Governance in Japan", May 2008

Over the years, F&C has encouraged companies to improve board practices through a number of tactics including: writing annually to every Japanese company that F&C and our ***reo***® clients holds to explain our voting policy; exercising our voting rights at annual company meetings; disclosing our reasons for votes against management; engaging companies on environmental, social and governance (ESG) issues one-to-one and on a collaborative basis; and travelling to Japan on a regular basis to meet companies face-to-face. F&C speaks with companies in Japanese as we believe this to be the most effective strategy to get our message heard.

As a response to the Olympus and TEPCO incidents as well as the increased flow of investments into Japan, F&C intensified our engagement in 2012 and 2013. We travelled twice to Tokyo, in September 2012 and in March 2013, where we met with approximately 30 companies face-to-face to discuss material ESG issues. Company meetings included Olympus, TEPCO, **Nippon Steel & Sumitomo Metal, Takeda Pharmaceutical, Japan Tobacco, Sumitomo Corporation** and **Toyota.**

In the spring of this year, we launched a project targeting the 15 largest companies in Japan (by market capitalization) still maintaining an all-insider board. These included **Fanuc, Nintendo** and **Kyocera.** We wrote to the Chairman or President of these companies highlighting the importance for listed companies to have a sufficient number of non-executive board directors from outside the company. Reasons we cited include:

- Independent oversight of management without a conflict of interests;
- Representation of the interests of minority shareholders;
- Strategic thinking that is independent from executives;
- Management experience and expertise developed from outside;
- Diversity of opinion – by including international or female directors.

Six of these companies introduced an external director during the June AGM season. The most surprising was industrial robotics maker Fanuc, as the company had been traditionally secretive, reluctant to meet investors, and resistant to change. In total, F&C has reported to clients 86 corporate governance enhancements in Japan during 2013. These milestones are instances where we identified improvements in board structure that F&C directly commented on via engagement and/or voting activity.

Alongside direct communication with companies, F&C's ongoing strategy in Japan is to engage a wide range of stakeholders. We believe strongly that this is the most effective route to securing change at the company level. In recent months, we have held discussions with:

- **Regulators** including the Japan Financial Services Authority (FSA).
- **Government ministries** such as the Ministry of Economy, Trade and Industry.
- **Business groups** such as the Keidanren.
- **Tokyo Stock Exchange** which is the main Japanese proponents of governance reform.
- **Government advisors and academics**, specifically those who play a critical role in setting the policy agenda and making recommendations.
- **Consultants** who are hired to collect the opinions of international investors.
- **Japanese asset managers and asset owners** who traditionally have played a passive role with investee companies.
- **International institutional investors** such as other Asian Corporate Governance Association members. We also participate actively in the UK-based Japan Focus Group.

### F&C 2013 voting record in Japan

As part of our objective to target companies with all-insider boards, F&C tightened its voting rules in Japan this year. We decided to vote against all directors, including Chairman and President, at companies with no external directors.

In 2013 – up to mid-October – F&C had voted at 700 Japanese company meetings. Our 'votes against management' rate is currently 54 per cent. This is a considerable decline from 62 per cent in 2012. This shows that the overall improvement in governance standards in Japan has more than offset the tougher voting rules we have put in place. That said, Japan will almost certainly remain as the market with the highest votes against management recommendations of the 70 or so countries in which F&C voted in 2013.

Major AGMs in 2013 have included Toyota's. The carmaker introduced three outside directors for the first time and F&C supported the entire boards election in reflection of this reform. While at the other extreme, camera giant **Canon** chose to maintain its all-insider board and F&C voted against the entire board including the charismatic Fujio Mitarai. He is joint Chairman, President and CEO. He also served as Chairman of the Keidanren between 2006 and 2010.

### They said...

**"We believe that familiarity with current on-site conditions is integral to more effective and efficient decision-making. Accordingly, the company does not presently appoint outside directors."**

**Canon**

### We said...

**"Canon's management appears to be turning in on itself at a time of major operational and strategic challenges for their global business, when instead F&C believes that the introduction of independent outside directors would be a positive dynamic that could act as a catalyst for clearer strategic direction."**

**Jamie Jenkins, Head of Japanese Equities, F&C Investments**

### Conclusion and next steps

There is no doubt that Prime Minister Abe has succeeded in forcing a much-needed sense of urgency for economic reform and in stirring the conservative board rooms of Japan Inc. into action. F&C believes that governance reform was in part the fruition of years of consistently calling for change by a small community of international investors. We are encouraged by these developments, but Japan has far to go before its governance practices are close to Western counterparts. As a result, F&C plans to maintain our intensity of engagement in Japan in the coming year.

In addition to ongoing board reform, there are two major developments on the horizon between now and the next annual meeting season in June 2014. First of these is the process to establish the Japanese version of the UK Stewardship Code. The Japanese FSA is leading the efforts and this code is expected to require institutional investors in Japan to improve disclosure of their voting policies and records (almost all asset managers disclose some voting information already), and to engage with investee companies.

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[5] Towers Watson

Japanese asset managers and owners have traditionally played a relatively passive role engaging investee companies. This is largely due to the conflict of interest they face as many of them are part of a large business network (called the keiretsu). This means that either they are subsidiaries of larger corporations – in which they own large blocks of shares – or enjoy long lasting business relationships. Very few (if any) are genuinely independent entities. Maintaining harmony in these business relationships may get in the way of a Japanese asset manager's willingness to engage major corporations, especially at a meaningful level to urge change in areas that would improve investment outcomes. F&C has engaged a number of advisors to the Japanese government who are currently drafting the code. F&C is recommending that any code be bolstered with a requirement for systematic reporting of an asset manager and owner's Stewardship approach and related activities. We believe this has contributed to enhancing the accountability of signatories to the UK Stewardship Code. It is expected that a draft will be finalised by the spring of 2014.

Secondly, some Japanese companies are indicating an improved approach to remuneration. Unlike the US, UK and a number of other Western markets, there is no requirement in Japan for companies to seek non-binding approval from shareholders on executive remuneration packages. Currently, Japanese companies are required only to disclose their compensation policy and pay for directors when it exceeds approximately US$1 million.

F&C's study of Japanese pay practices reveals that while absolute levels of pay are not an issue, the link between pay and performance is weak – especially those indicators related to shareholder returns. The average ratio of fixed to variable pay is three-to-one. Compare this to the US where it is one-to-three[5]. F&C is increasing its engagement with companies on this issue – especially the major commercial banks which are considered to have systemic risk and are likely to receive extraordinary government support in a time of need. This is a risk that affects both share and bond-holders. F&C strives to ensure that the pay policy of executives at Japanese financial institutions reflect the right balance of risk-taking and risk-management. In 2013, we wrote to the Chairmen of **Sumitomo Mitsui Financial Group, Mitsubishi UFJ Financial Group, Mizuho Financial Group,** and **Shizuoka Bank** to highlight our position on this issue.

2014 is expected to be the year of truth for the Japanese Prime Minister. He will be under enormous pressure to start achieving concrete results with his Abenomics policies. F&C believes that many of the goals of the government and international investors are aligned. We both want to see a revitalised corporate Japan that is growing and attracting foreign capital. F&C will capitalize on the government's push for reform by intensively engaging companies which have weak governance practices – especially all-insider boards – and continue to push for a stronger recognition of shareholders' rights.

*For clients with access to F&C's **reo®** Partner Portal, the details of all the engagement and milestone highlighted here is available by using the GSI Companies or search function (type in the company name) to find the company. Clients can also click on the Engagement Projects tab to find details of the "Japanese Corporate Governance Project" in which we engaged companies with all-insider boards.*

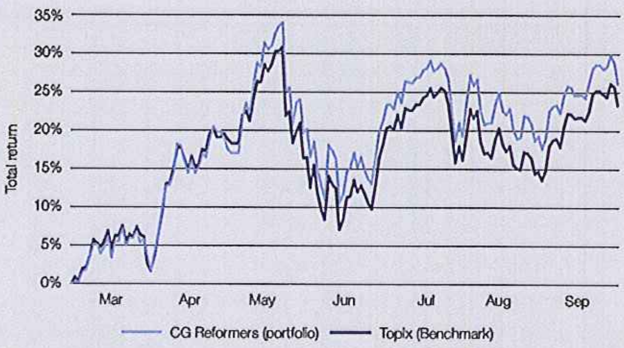
If you would like further details on the information in this note, please contact your ***reo®*** client director.

## The impact of governance reform?

A key reason given by many Japanese corporations as to why they do not want to reform their governance structure is the lack of financial benefit for doing so. In recent years, there have been a growing body of academic research supporting the case for good corporate governance and shareholder returns.

To add to this research, F&C investigated the difference in returns between an equity portfolio constituting the companies that introduced an outsider to the board for the first time in 2013 versus the benchmark TOPIX index. In this simple exercise:

- F&C created a portfolio of 112 stocks. Weightings were a derivative based on the parent TOPIX benchmark index. Weightings were allowed to drift.
- The start date was set as March 1st 2013. This was before the companies had started to publicly indicate their plans for director elections in the June AGM season. End date was September 30th 2013 (7-month period).
- Total Return – including returns from share price changes and dividends – (in Japanese Yen) was selected as the measure for investor returns.




Currency: Japanese Yen
Source: Bloomberg

The results show that at the end of the experiment period on September 30th the portfolio had outperformed the benchmark by 2.8%. The largest difference in performance was in mid-August where the portfolio was outperforming by 4.8%.

The portfolio and benchmark tracked each other closely for the first two months of the experiment period. Then from early May through to the middle of the voting season in June, the portfolio outperformed by 4% or so. It is interesting to observe that the period in which the biggest gains were made coincided with when the disclosures for board director elections took place. We also saw very similar results when the portfolio was benchmarked against FTSE Japan (the industry benchmark for Japanese equity funds).

Of course, there are severe limitations in a study of this basic nature and short timescale. F&C accepts that there is little concrete data that could be concluded from this study in the long-run and a similar result may not be replicated in 2014. Nevertheless, F&C considers it interesting that employing governance reform as an investment strategy would have had this outcome in 2013. We hope this adds to the points of discussion amongst all stakeholders interested in governance reform in Japan.



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